Educational

Monetary Policy Implementation Framework and Outcome

Prior to the banking sector consolidation exercise that was concluded in December 2005, the framework for monetary policy in Nigeria had witnessed some transformation. This included the shift from the use of direct monetary policy control to indirect (market-based) monetary management, and the switch from short-term framework to a two-year medium-term framework in the conduct of monetary policy. Although the objectives of monetary policy remained basically the same and monetary aggregates remained the intermediate target for achieving the ultimate objective of inflation during this period, there were some fundamental changes in the strategies and instruments employed in the conduct of monetary policy in order to cope with the evolving financial environment. These changes are phased as shown below.

Era of Direct Control (Pre-SAP Period)

Prior to the introduction of the Structural Adjustment Programme (SAP) in the mid 1980s, the monetary policy framework placed emphasis on direct monetary controls. This was essentially due to the relatively underdeveloped nature of money and capital markets in the country then. The framework relied heavily on sectoral credit allocation; credit ceilings and cash reserve requirements; administrative fixing of interest and exchange rates; as well as imposition of special deposits. During this period the set monetary targets were hardly realized. Instead, the strategy created a lot of distortions and bottlenecks in resource allocation, resulting in wide spread inefficiencies in resource allocation and utilization.

Period of Indirect or Market Approach (Post-SAP Era)

In line economic deregulation embodied by SAP, there was a paradigm shift from the hitherto repressive direct monetary control method to an indirect approach anchored on the use of market instruments in monetary management. This was borne out of the desire to eliminate the distortions and inefficiencies in the

financial system caused by the prolonged use of administrative controls and the need to engender competition among banks and other operators in the financial system. Two major policy regimes of short- and medium-term frameworks can be identified.

Regime of Short-Term Monetary Policy Framework (1986 – 2001)

Consistent with the broad objectives of monetary policy, a number of monetary targets and instruments were adopted during the short-term (one-year) monetary policy framework (1986 – 2001). OMO, conducted wholly using the Nigerian Treasury Bills (NTBs), continued to be the primary instrument of monetary policy. This was complemented by the cash reserve requirement (CRR) and the liquidity ratio (LR). Other policy instruments employed included the discount window operations, mandatory sales of special NTBs to banks and a requirement of 200 per cent treasury instrument to cover for banks' foreign exchange demand at the Autonomous Foreign Exchange Market (AFEM). Interest rate policy was deregulated through the proactive adjustment of minimum rediscount rate (MRR) to signal policy direction consistent with liquidity conditions. Surveillance activities of the CBN focused mainly on ensuring sound management and maintenance of a healthy balance sheet position on the part of deposit money banks (DMBs). On the external front, the official and inter-bank exchange rates were unified in 1999.

In spite of the reforms in the articulation and execution of monetary policy during this period, most of the monetary and financial targets were substantially missed. As can be observed from Table 1, the actual growth rates in broad measure of money supply (M2) and aggregate bank credit for the years, 1999 – 2001, were higher than the targets by wide margins. Although, inflation performed better in two of the three years, aggregate output was sluggish during the period. The major problem could be attributed to the expansionary fiscal policies of the three-tiers of government and the resultant liquidity overhang, as well as lack of coordination of monetary and fiscal policy implementation.

Regime of Medium-Term Monetary Policy Framework (2002 – 2005)

In 2002, the CBN commenced a two-year medium-term monetary policy framework, aimed at freeing monetary policy from the problem of time inconsistency and minimizing over-reaction due to temporary shocks. The new monetary policy framework, still in operation, is based on the evidence that monetary policy actions affect the ultimate objectives with a substantial lag. Under the new framework, monetary policy guidelines are open to half-yearly review in the light of developments in monetary and financial market conditions in order to achieve medium- to long-term goals.

The major objectives of monetary policy since the 2002/2003 period have been to subdue inflation to a single-digit level and maintain a stable exchange rate of the naira. Attention has also been focused on the need for a more competitive financial sector geared towards improving the payments system. The OMO has continued to be the primary tool of monetary policy, and is complemented by reserve requirements, discount window operations, foreign exchange market intervention and movement of public sector deposits in and out of the DMBs. The CBN has also continued to ensure banking soundness and financial sector stability, not only to ensure the effective transmission of monetary policy to the real sector but also to enhance the efficiency of the payments system.

The measures taken to strengthen the banking sector and consolidate the gains of monetary policy included the introduction of a 13-point reform agenda in the banking sector in July 2004 (the key point of which was the ₦25 billion minimum capital base for DMBs). The 2004/2005 monetary policy and credit guidelines were fine-tuned in 2005 in the light of changing environment. New policy measures introduced included maintenance of a tight exchange rate band of plus/minus 3 per cent, two-week maintenance period of cash reserve requirement and the injection/withdrawal of public sector deposits from the DMBs. The various measures put in place, complemented by improved fiscal

discipline at the federal government level, impacted positively on the monetary aggregates in 2004 and 2005, resulting in achievement of set targets during the period. The CBN was able to achieve the targets by being pro-active in the implementation of sound monetary policies, including zero tolerance on government borrowing from the CBN.

Monetary Policy, Post-Banking Consolidation (2006-2007)

Two key features have defined the monetary policy landscape in the post consolidation period, 2006/07: persistence of excess liquidity despite reversal of historic conditions, for example, ways and means and emergence of a new but very important source of excess liquidity -increased private inflows. The objectives of monetary policy during this period have however remained unchanged. Current monetary policy strategy involves (amongst others):

- Zero tolerance on ways and means advances
- Gradual run-down of CBN holding of TBs
- Aggressive liquidity mop-up operations-frequent OMO sales supported by discount window operations
- Unremunerated reserve requirements
- Increased coordination between the Bank an the fiscal authorities
- Restructuring of debt instruments into longer tenor debts
- Increased deregulation of forex market, and
- Occasional forex swap

The strategy is complimented by on-going reforms of monetary policy in particular and the financial system in general.

The reform of the financial system, a key component of which was bank consolidation, was intended to minimize macroeconomic instability arising from banking systemic distress; motivate intermediation through the deepening of the capital market; finance productive sector growth in the private sector, particularly non-oil growth; minimize the counterfactual shocks of creating distortions in the

money markets and the financial system; encourage investment inflows through effective participation of the industry in the global financial system, among others. As a direct consequence of the exercise the capital base of Nigerian banks (combined) increased from about US$2.5 billion in June 2004 to about US$5.8 billion at end-December 2005. This has been accompanied by rising inflow of foreign investment in the sector till date. Virtually all the banks have been listed in the Nigerian Stock Exchange (NSE) with the capital market becoming more liquid and more capitalized. The banks now have the potential to finance big investment transactions as their single obligor limits have increased, while regulation and supervision have become more effective given that ownership has been diluted with more regulators having the legal authority to oversee them. The CBN now focuses on a fewer number of banks. This has raised efficiency of supervision resulting in zero tolerance towards infractions and improved corporate governance. Greater transparency is being enforced and the deployment of IT infrastructure (eFASS and RTGS) has significantly helped the process.